JANUARY 2025

# Is it Time to Start Allocating to Canadian Retail?

## The Introduction & Key Highlights

The Canadian retail real estate sector has lost investor appetite over the last several years. E-commerce has weighed on the retail sector while significantly boosting the relative outperformance of industrial properties. However, a recent resurgence in retail performance and investment, particularly in Q2 2023, has sparked renewed interest in this relatively forgotten property type.

This paper explores the key factors shaping Canada's retail environment, including retail space per capita relative to other developed nations, household debt, mortgage rollover risk, and key digital transformation trends. It also identifies major bifurcations in the sector by looking at the differing prospects for discretionary and staple retail segments and quality divergences, marked by luxury versus middle-market versus discount retail.

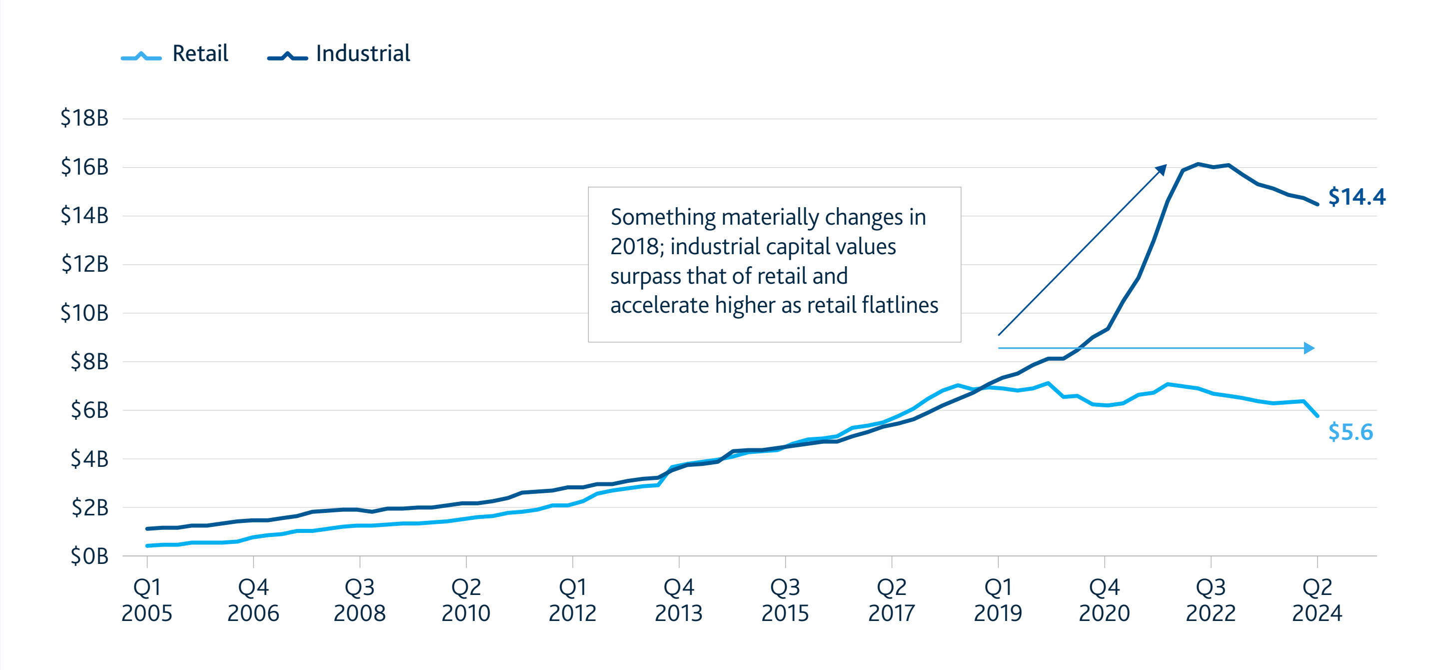
Finally, it analyzes the investment prospects of the sector by examining valuation trends, forecasting expected rental growth, and determining whether recent outperformance is something more durable. *The paper concludes that the retail sector should not be relied on for outsized growth, like industrial and multi-residential real estate. It should be considered a "neutral" allocation, offering stable, higher income with inflation-like capital growth at best, thus serving as a valuable diversifier within a Canadian real estate portfolio.*

# Is Retail Back on Institutional Investor Radars?

In recent years, much like the global retail landscape, Canadian retail has undergone a dramatic transformation, driven largely by the explosive growth of e-commerce and online shopping. It appears that consumers increasingly prefer the convenience of purchasing goods from their devices, bypassing traditional bricks and mortar stores. This shift is unmistakably reshaping the commercial real estate sector, as retailers re-evaluate the need for physical storefronts. The result? A significant and well-documented cannibalization of in-store sales, with many businesses downsizing or closing their physical locations in response to the relentless pressure of e-commerce. This structural trend can clearly be seen in the behaviours of Canadian institutional investors managing open-ended real estate funds. Around 2018, Figure 1 shows that funds included in the MSCI/REALPAC Canada Quarterly Property Fund Index ("PFI") began heavily adding to their industrial positions at the expense of retail, assuming transportation and warehouse users would benefit from the e-commerce trends.

**Figure 1**

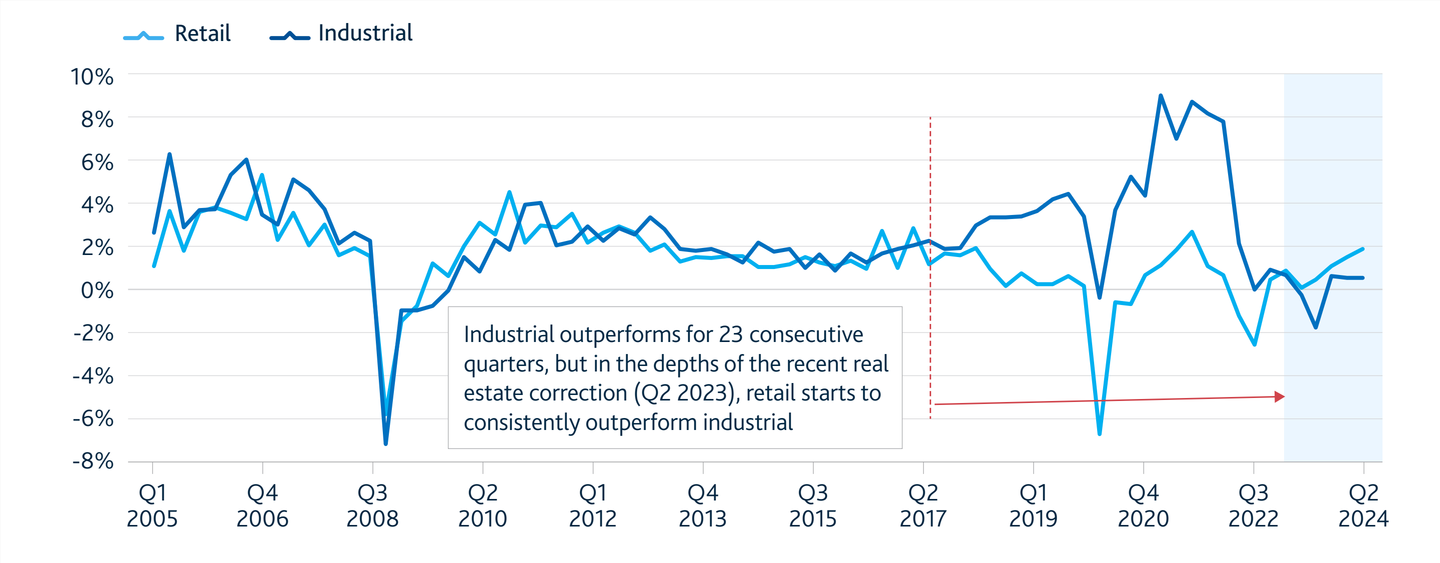
### PFI Capital Values: Retail vs. Industrial[1]



That capital allocation decision was unambiguously correct, as industrial total returns trounced that of retail for 23 consecutive quarters until Q2 2023 (Figure 2).

**Figure 2**

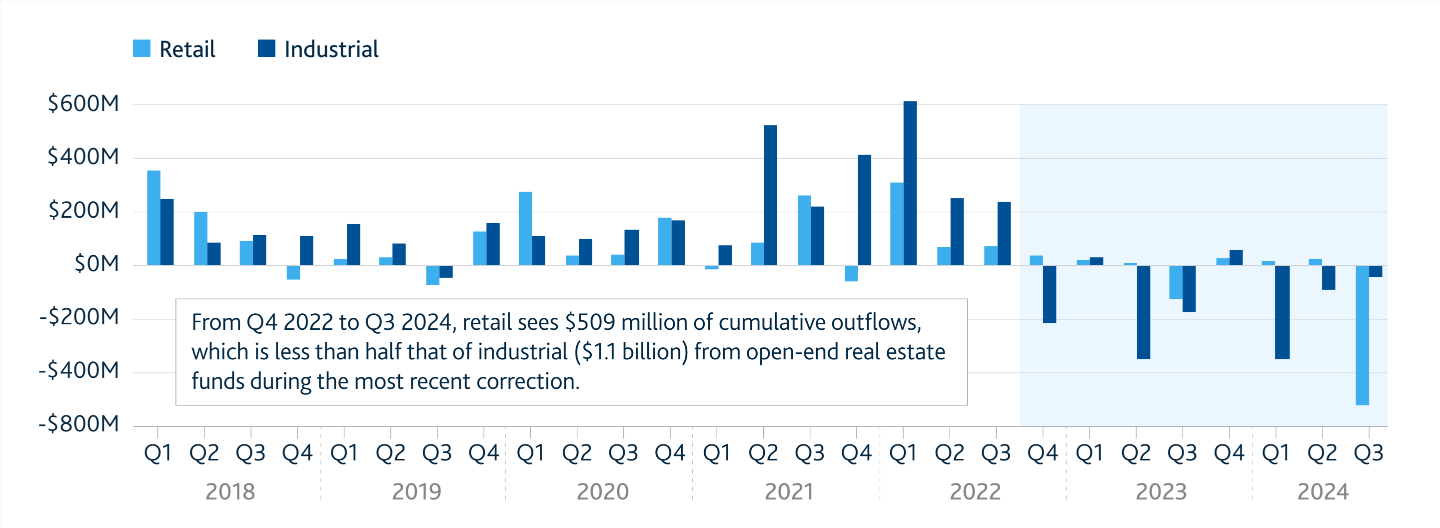
## PFI Total Returns: Retail vs. Industrial[2]




During the recent real estate correction, however, retail has been seen as a safe-haven and has continued to outperform industrial for six quarters and counting, while net investment also showed its resilience, relative to industrial. (Figure 3).

**Figure 3**

## PFI Net Investment: Retail vs. Industrial[3]




Is this a durable turning point for retail? Investors might be wondering if it's time to consider reallocating to retail, much like they did during the 2005-2018 period.

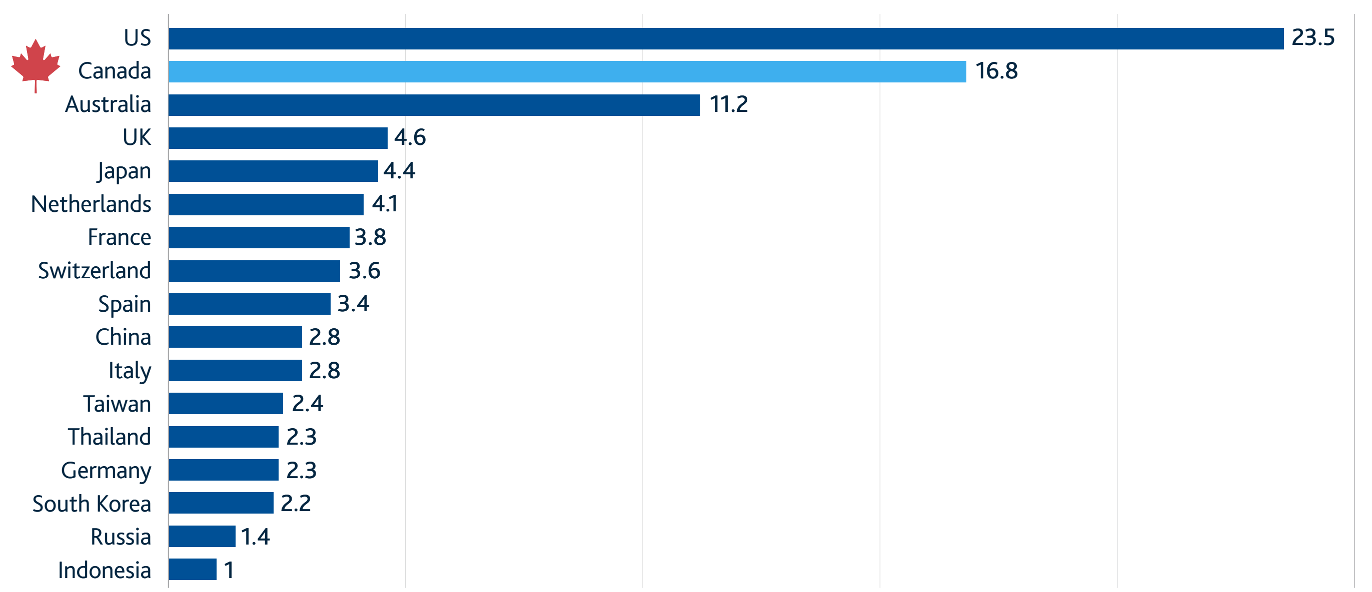
# Headwinds For Bricks And Mortar Retail Sales

## Canada is Over-Retailed

Canada boasts one of the highest retail spaces per capita among developed nations, second only to the United States ("US"). This saturation has created a highly competitive market where many retailers struggle to maintain profitability. For instance, Figure 4 shows that the retail space per capita in Canada was approximately 16.8 square feet ("sf") in 2018, compared to 23.5 sf in the US, highlighting the extensive retail infrastructure.

**Figure 4**

### Retail Space per Capita (Square Feet)[4]




Based on database provider, CoStar, Canada's retail space per capita was higher than that, at 21.4 in Q4 2018. Even though retail inventory has grown at an annualized rate of 0.5% since Q4 2018, most of the new deliveries have occurred in mixed-use construction projects.[5] Canada's population growth has eclipsed retail inventory growth (growing at 1.2% annualized over that same time period)[6], allowing Canada to grow into some of its retail space per capita. Nevertheless, the country remains with an excess retail capacity and is four to five times more retailed than many European countries.

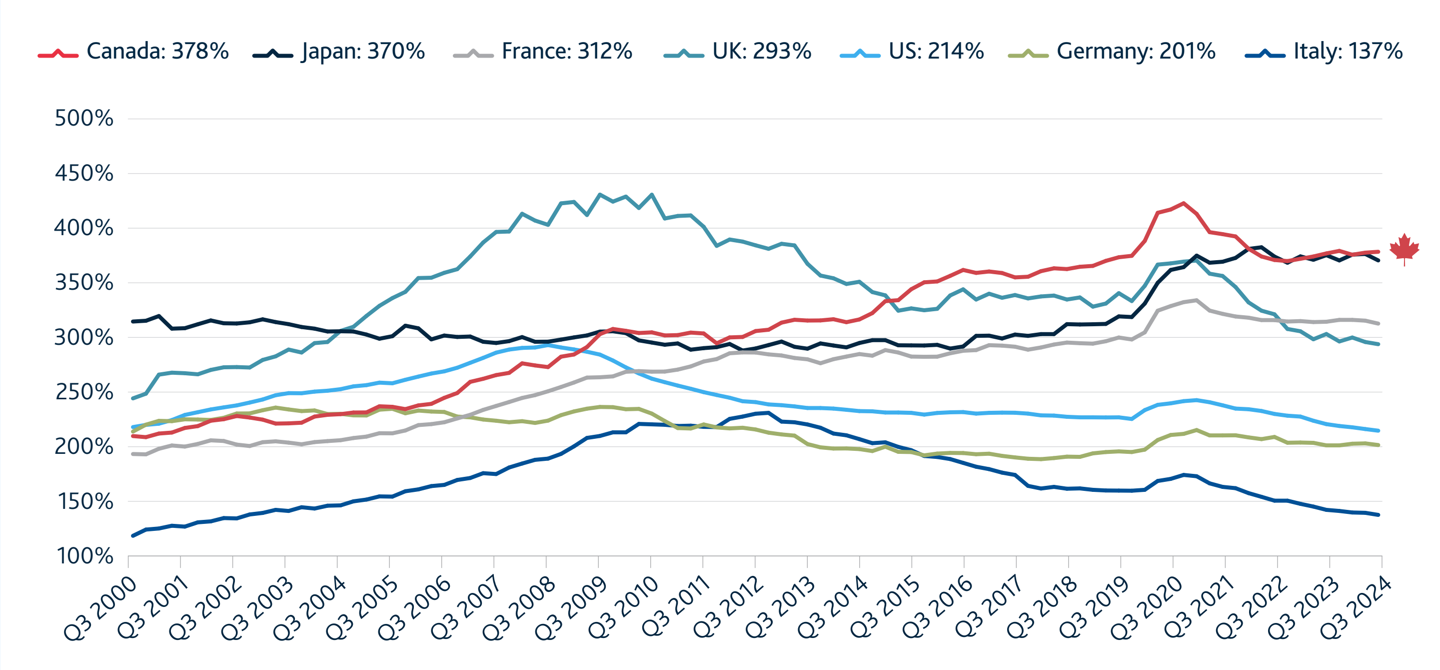
## Canadian Consumers are Over-Leveraged

Canadian consumers are among the most indebted in the world, with household debt levels reaching 176.4% of disposable income[7], or 102.1% of Gross Domestic Product ("GDP"). The second closest G7 country by the debt to GDP metric, is the United Kingdom ("UK") at 77.5%.

When looking at the private sector more fulsomely (households and corporations), Canada takes first place and leads Japan narrowly at 378% debt to GDP (Figure 5).

**Figure 5**

### G7 Countries: Private Debt to GDP (Households & Corporates) – Q3 2024[8]




This indebtedness limits future consumer spending power and heightens economic vulnerability.

## Canada has Upcoming Mortgage Rollover Risk

Mortgage rollover risk, the danger of rising interest rates increasing mortgage payments upon renewal, significantly affects Canadian homeowners. As interest rates climb, a larger portion of household income is directed towards mortgage payments, reducing discretionary spending.

According to Canada Mortgage and Housing Corporation's ("CMHC") Fall 2024 Residential Mortgage Industry Report, there are 7 million active loans with an outstanding balance of $2.2 trillion.[9] Of the mortgages outstanding as of July 2024, 1.2 million and 980,000 will come up for renewal in 2025 and 2026, respectively. Most were contracted (85%) when the Bank of Canada rate was at or below 1%, exposing borrowers to significantly higher renewal rates or a payment shock. This payment shock will be most significant for homeowners who took out mortgages when interest rates were lower in 2020 to 2022. The Office of the Superintendent of Financial Institutions ("OSFI"), Canada's watchdog government agency responsible for regulating and supervising more than 400 financial institutions and 1,200 pension plans, expects payment increases to lead to a higher incidence of residential mortgage loans falling into arrears or defaults.[10]

For context, assuming Canada's $2.2 trillion of residential mortgages roll to an interest rate that is 1% higher than the previous term, this would take a $22 billion annual bite out of Canadians' wallets (2.6% of current total retail sales)[11], which could otherwise be used for discretionary retail spending.

## Canada Lends Itself Well for Retail Digitization

Canada is well-positioned for retail digitization due to its high internet penetration and tech-savvy population. According to the Global E-Commerce Outlook by CBRE Research, Canada's online adoption rate is among the highest in the world, ranking sixth, as online sales represented 6% of total sales in 2016 and nearly 20% in 2021.[12] Yes, the COVID-19 Pandemic can claim responsibility for skewing the numbers, but it clearly acted as a catalyst to accelerate an existing structural trend. The report identified 28 growth factors and split the top ones into four basic categories.

**Demographics** – Urban population density, employment in services

**Usage** – Digital skills of population, mobile internet ratio, dominant e-commerce player

**Cultural** – Credit and debit card use/digital wallets

**Infrastructure** – Fixed broadband subscriptions, transport infrastructure and timeliness of shipments

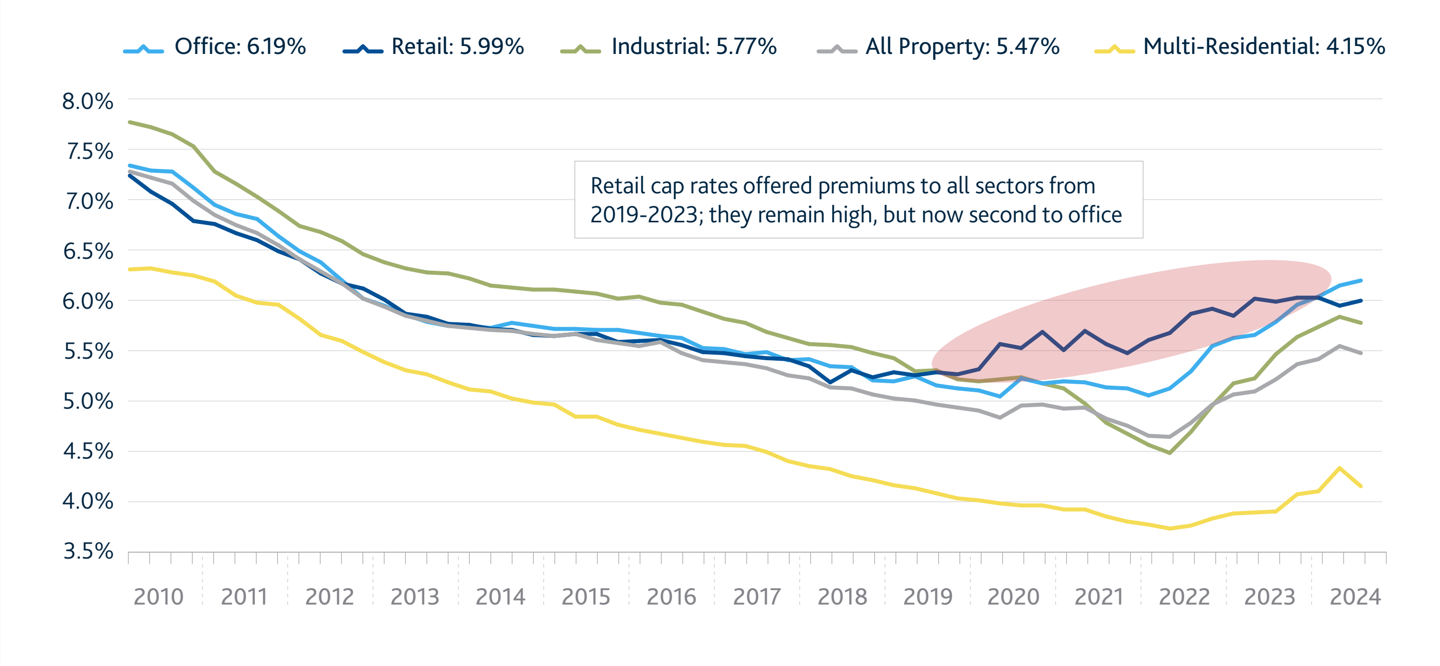
Canada ranks tenth in the world based on these key drivers. This results in CBRE's forecast where it is indicated that by 2026, online sales should represent an impressive 27% of Canada's total retail sales.

# Retail Valuations and Market Fundamental Trends

Retail valuations in Canada have been subdued over the past five years, partly due to the sector being broadly shunned by institutional investors (Figure 6).

**Figure 6**

## PFI Cap Rates by Sector[13]




However, throughout this period of weakness in fundamentals and market conditions, tenants have adjusted and continue to adjust by right sizing their physical footprints. With recent demand for space remaining moderately positive and new retail supply limited to mixed-use developments, overall retail fundamentals remain generally balanced in Canada. According to CBRE, of the 7.0 million sf currently under construction, 5.3 million sf is new, while the remaining 1.7 million sf is either a renovation, redevelopment, or expansion.

Figure 7

## Retail Market Fundamentals - Regional Shopping Centres vs. Power Centres[14]

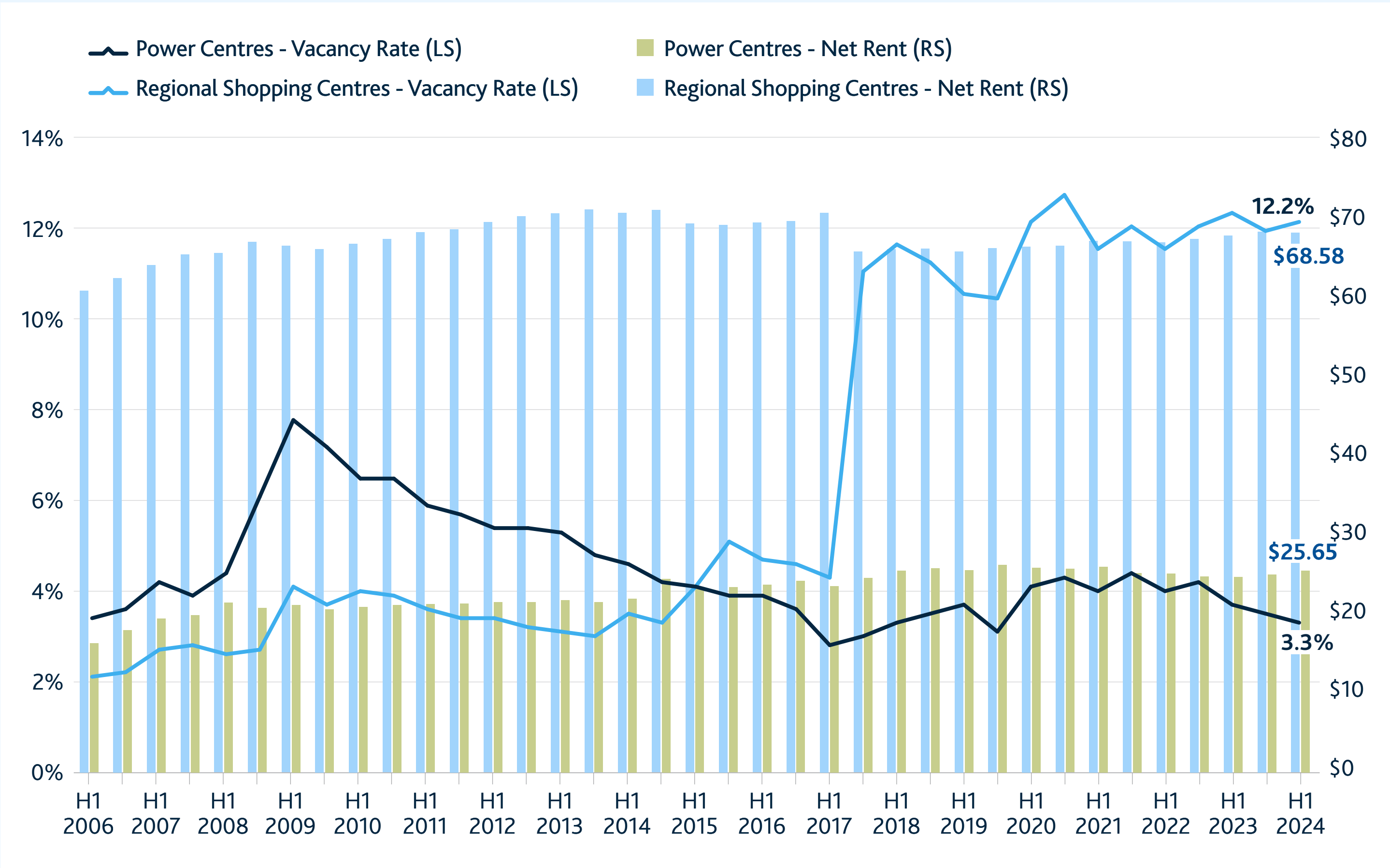



Figure 7 shows that Regional Shopping Centres (middle-market malls) saw a sharp rise in vacancy rates *before* the COVID-19 Pandemic began. Vacancy rates still sit around 12.2%, but the more defensive Power Centres (open-air centres likely to be food or drug-anchored) only have vacancy rates of 3.3% and their net rents appear to be stabilizing from 2017-2018 levels. The entire market has a modest vacancy rate of 6.2% as of H1 2024, suggesting it remains balanced relative to history.

# Retail Bifurcations

## Bleak Prospects for Consumer Discretionary Retail

Even though the Bank of Canada has cut interest rates 175 basis points since June 2024, the policy rate still remains elevated. According to David Rosenberg featured in a Financial Post article late last year, around two-thirds of Canada's mortgages by value will be coming up for renewal over the next three years, shifting borrowers from the ultra-low rates available during the pandemic to much higher ones. If rates stay at current levels, that will push the average monthly mortgage payment up by 15% in 2024, 30% by 2025, and 45% by the end of 2026, per Rosenberg's report. In aggregate, all those extra interest payments would amount to a 20% reduction in the national disposable income by the end of 2026. Households that opt to restructure their debt would have to draw down their savings. Others who decide to sell their homes will put pressure on an already softening housing market, while those left with no choice but to default will put Canadian banks at risk of losses.[15]

So, what does this all mean? Higher interest rates for longer have potential to reduce Canadian disposable purchasing power by 20%, and consumer spending is roughly two-thirds of GDP. If GDP (the denominator) deeply contracts, then the total debt to GDP ratio explodes higher to even more unsustainable levels. The US can go longer with higher rates because it has higher structural growth, less total debt, and less interest rate sensitivity due to extended mortgage terms – some as high as 30 years, something not available in Canada.

Unless interest rates can drastically drop to open a refinancing window whereby the mortgages of 2020-2021 can roll at similar or moderately higher rates, the future for discretionary retail in Canada appears bleak, even with robust immigration levels. Newcomers to Canada may not substantially boost discretionary spending due to the high cost of living and debt burdens. Additionally, the continued shift towards online shopping diverts potential revenue from physical stores, further dampening prospects for bricks and mortar discretionary retailers.

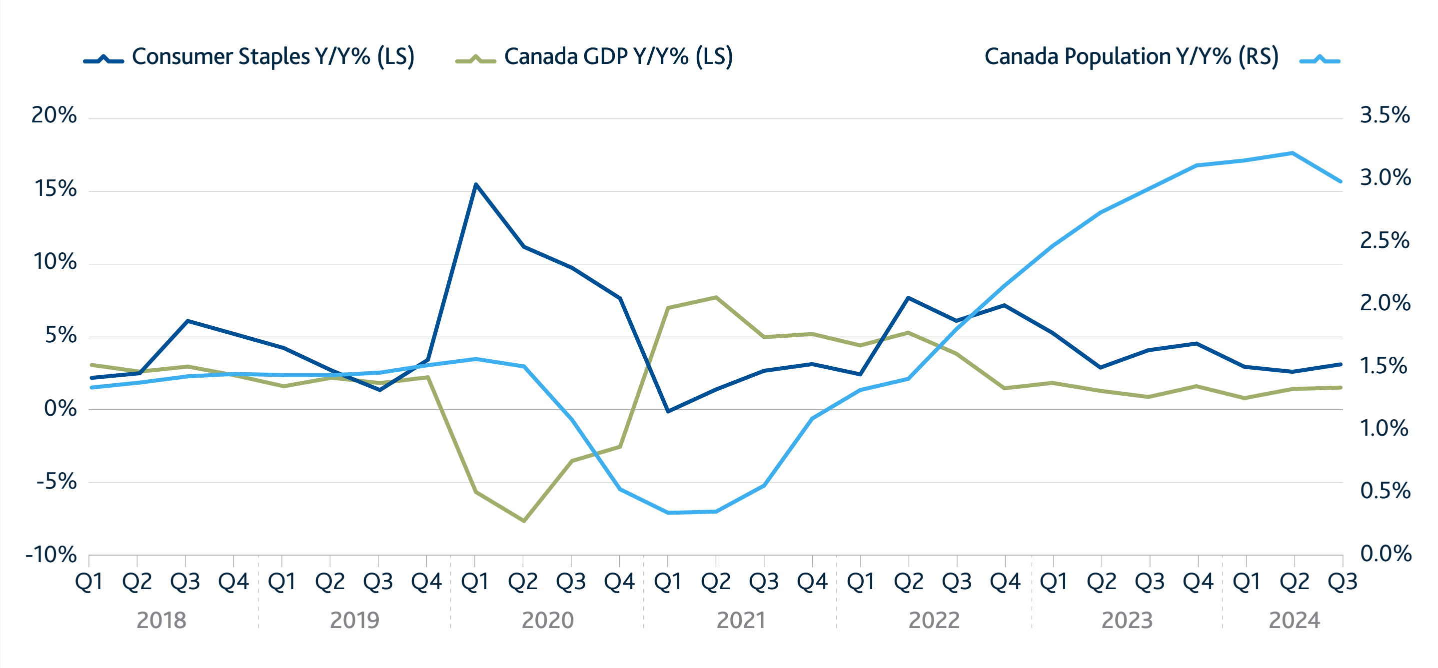
## Consumer Staple Retail Should Relatively Outperform

Consumer staple retail, including food and drug stores, is less cyclical and more influenced by population growth because staples are essential, making their demand relatively stable and inelastic. A comparative analysis reveals that while discretionary retail fluctuates with economic cycles, staple retail shows consistent growth aligned with population increases.

The graph in Figure 8 aggregates the most defensive subsets of retail spending (food and beverage retailers, general merchandise retailers, and health and personal care retailers) and labels it "Consumer Staples." This figure is then compared on a year-over-year percentage basis ("Y/Y%") to Canada's GDP and population growth.

**Figure 8**

### Consumer Staples Retail vs. GDP and Population Growth[16]




Simple correlation coefficients show that "Consumer Staples" retail sales have a strong relationship to Canada's GDP, at 0.81. Historically, when economic activity expands/contracts, retail sales that meet the most basic of needs such as food, health and personal care also expand/contract, but at a pace that is less than one-to-one. Intuitively, this makes sense that "Consumer Staples" have a lower sensitivity to Canada's economy, therefore are more defensive. Comparing the same baseline figure to Canada's population, the relationship is exceptionally strong at 0.95. As Canada's population continues to grow, Consumer Staples retail sales should grow alongside it. These are favourable properties given what has been observed in this paper so far.

## Resistance to Digitalization in Consumer Staple Retail

Food and drug retail sectors are less susceptible to digital disruption due to the necessity of physical presence, immediate consumption, and logistical challenges in delivering perishable goods. Electronics is currently the leading product category as it is most conducive to online sales, followed by fashion and furniture. The products that Canadians are buying from US-based merchants are apparel and accessories, followed by books, music, and videos; consumer electronics; toys, hobbies, and games; health and beauty products; footwear; jewelry; household goods; sporting goods; garden supplies; and groceries.[17] While online grocery shopping is growing, it still represents a small fraction of total grocery sales at a 4.1% of the e-commerce market in 2023.[18] This resistance helps maintain the relevance and stability of bricks and mortar stores in this segment.

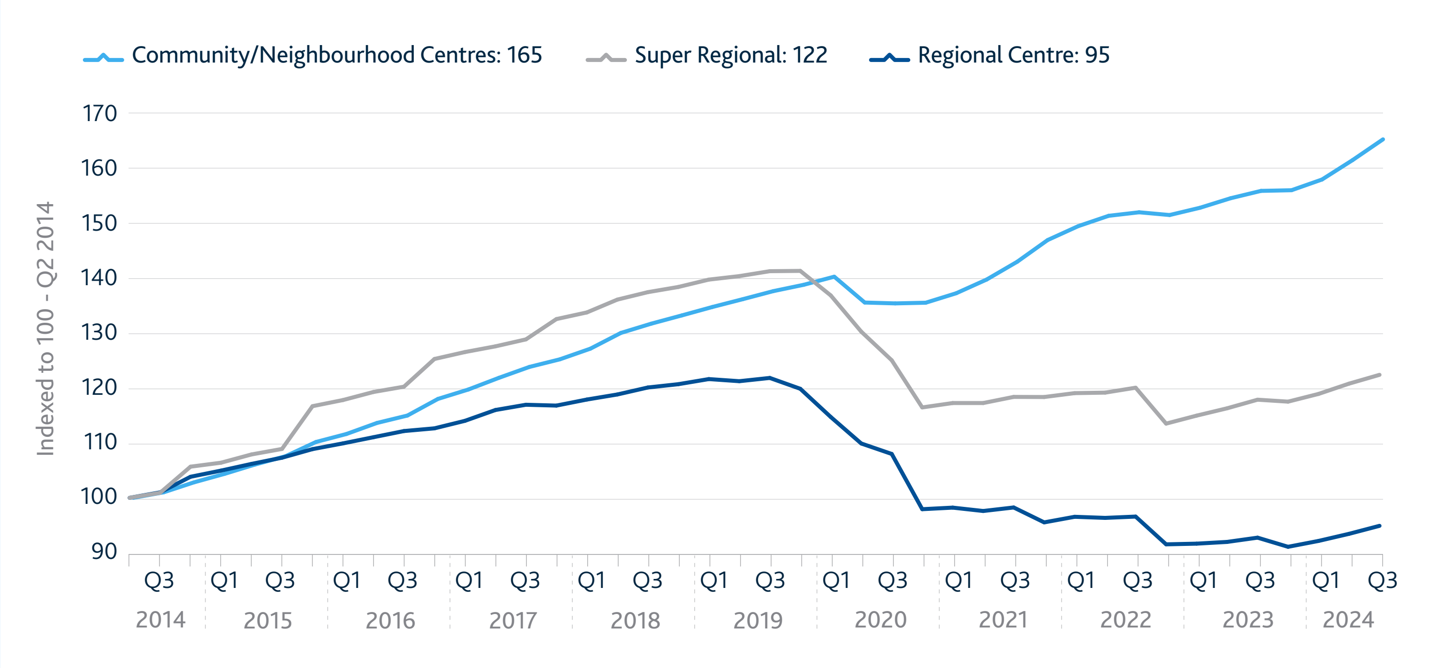
## The Niche Role of Luxury/Experience and Discount Retail

Luxury and experience retail continues to thrive because it caters to the fundamental human desire for social interaction and unique experiences. As social beings, people are drawn to environments that offer not just products, but memorable moments and personalized service, allowing them to connect with brands and communities on a deeper level. These experiences fulfill emotional and psychological needs, offering a sense of exclusivity and personal enrichment that transcends mere transactional shopping. Meanwhile, discount retail remains popular due to the economic realities faced by many households today, particularly in a world burdened with significant levels of debt. Consumers often seek affordable options to stretch their budgets, making discount retail an attractive option for purchasing essentials without compromising financial stability. This dual landscape of retail – luxury for those seeking enrichment and discount for those prioritizing affordability – illustrates the diverse needs of consumers in a complex economic environment. It also appears that a version of wealth inequality is developing in Canada, similar to US.

Figure 9 shows that during the last 10 difficult years for the sector, Community/Neighbourhood Centres, which typically house discount and food or drug-anchored retail, and Super Regionals (representing the largest and most luxury focused malls in Canada) have materially outperformed Regional Centres.

**Figure 9**

### MSCI/REALPAC Canada Quarterly Property Index ("PI") Retail Segment Performance[19]



Regional Centres are smaller enclosed malls that typically house middle-level retailers (i.e., Hudson Bay anchored). Enclosed centres have extensive common areas that drive higher occupancy costs given the lower ratio of leasable area, thereby requiring a higher sales environment to ensure viability. Further, middle-level retailers, which traditionally offer products priced and positioned between luxury and discount stores, are facing significant challenges due to the rise of e-commerce and changing consumer preferences. These retailers are getting squeezed as consumers increasingly prefer the convenience, variety, and competitive pricing offered by online shopping platforms. E-commerce giants like Amazon have set high expectations for quick delivery and vast product selections, making it difficult for mid-tier retailers to compete on both price and convenience.

Additionally, these retailers often struggle to differentiate themselves in a crowded market. They lack the unique experiences and high-end appeal of luxury brands while also not being able to match the low prices and efficiency of discount retailers. This middle-ground positioning makes it challenging for them to attract and retain customers who are either drawn to the premium quality and experiences or the budget-friendly prices available elsewhere.

Moreover, the operational costs of maintaining physical stores, including rent, staff, and inventory management, put additional financial pressure on middle-level retailers. As consumer foot traffic in bricks and mortar stores declines, many of these retailers face declining sales and profitability. Consequently, some have been forced to close stores or even file for bankruptcy, unable to adapt quickly enough to the digital transformation that e-commerce represents. To survive, these retailers must innovate by integrating online and offline experiences and finding new ways to offer value to their customers.

**Figure 10**

## Retail Stock Performance : Luxury vs. Middle-Market vs. Discount[20]
## Returns in Local Currency (DOL.TO CAD, MC.PA EUR, M USD)

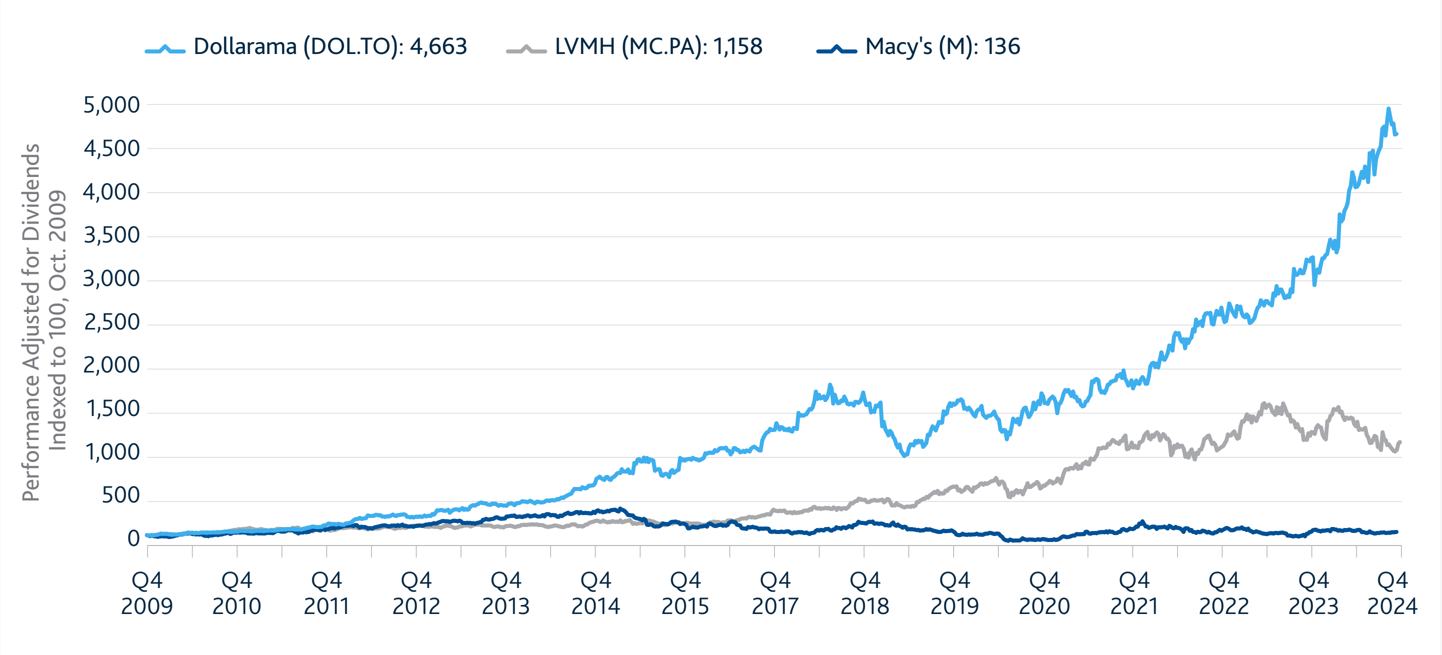


Figure 10 displays that Dollarama, representing discount retailers, has done very well since emerging out of the Global Financial Crisis ("GFC"), trading at over 46x its October 2009 level. LVMH, Louis Vuitton Moët Hennessy, a luxury retailer, has also performed quite well. Where the weakness exists is in the middle-retailer segment, as represented by Macy's on the chart.

For more proof of this point, Figure 11 shows a comprehensive list of recent middle-retailers store closures and bankruptcies. Most sell goods that lend themselves well to being sold online.

**Figure 11**

## List of Middle-Retailer Store Closures and/or Bankruptcies in Canada[21]

| Retailer | Year | Store Closure or Bankruptcy Details |
|---|---|---|
| Target Canada | 2015 | Exited Canada, closing all 133 stores due to unprofitability |
| Sears Canada | 2017 | Liquidated and closed all stores after failing to find a buyer |
| Zellers | 2020 | The final locations served as liquidation stores for Hudson's Bay |
| Best Buy | 2023 | Closure of 15 stores nationally |
| Pier 1 Imports | 2020 | Bankruptcy |
| Jacob | 2014 | Declared bankruptcy and closed all stores |
| Le Château | 2020 | Filed for bankruptcy protection, leading to store closures |
| Aldo Group | 2020 | Filed for creditor protection, impacting Canadian stores |
| Jean Machine | 2018 | Remaining stores closed |
| Addition Elle | 2020 | Part of a larger restructuring of its owner, Reitmans |
| Bowring | 2019 | Insolvency of owner Fluid Brands Inc |
| Staples | 2014 | Closed numerous locations and switched to online sales |
| Moores Clothing for Men | 2020 | Parent company filed for Chapter 11, affecting Canadian operations |
| Reitmans | 2020 | Filed for creditor protection, affecting multiple brands |
| David's Tea | 2020 | Closed many retail locations as part of a restructuring plan |
| Sail Outdoors Inc. | 2020 | Filed for bankruptcy protection due to COVID-19 impact |
| Gymboree | 2019 | Closed all Canadian stores after filing for bankruptcy in the US |
| Rona | 2016 | Closed numerous locations after being acquired by Lowe's |
| Carlton Cards & Papyrus | 2020 | Closed all retail stores in Canada |
| Forever 21 | 2019 | Closed all Canadian locations as part of global restructuring |
| Dynamite and Garage | 2020 | Filed for creditor protection, impacting physical locations |
| Bizou | 2021 | Closed several stores as part of restructuring efforts |
| Swimco | 2020 | Filed for bankruptcy and closed all physical stores |

Discount and luxury/experience retail segments show resilience amidst the broader retail challenges. Discount retailers benefit from consumers seeking value, while luxury/experience retailers attract those looking for unique shopping experiences.

# The Math – Determining the Near Future Growth Outlook for Retail

With the retail landscape now described, Fiera Real Estate will attempt to forecast a likely growth rate for the retail sector over the intermediate term – from now (Q3 2024) to end of 2028. Before attempting to do this, it is critical to first understand what a Gross Rent to Occupancy Cost ("GROC") ratio is. According to JLL, a GROC represents a retailer's total annual expenses associated with occupying a retail space and is expressed as a percentage of annual sales.[22]

Figure 12

## GROC Ratio Estimates for Retailer Types

| Retailer Types | Low | High |
|---|---|---|
| Grocery Stores | 3% | 5% |
| Apparel Retailers | 10% | 15% |
| Full-Service Restaurants | 8% | 12% |
| **Average Retailer** | **7%** | **11%** |

If we assume that 9% is the long-run equilibrium (the mid-point of the average retailer), we can forecast gross rents.

Figure 13

## Calculating Retail Gross Rental Growth until End of 2028

| Calculation | Data Point | Q3 2024 | 2028F | Annualized Δ% |
|---|---|---|---|---|
| - | A. **Retail Inventory square feet (sf)** [CoStar][23] | 825,855,351 | 836,073,164 | **0.3%** |
| - | B. **Canada Population** [Statistics Canada & Conference Board of Canada][24,25] | 41,288,599 | 43,164,000 | **1.1%** |
| A/B | C. **Retail Space per Capita** (sf) | 20.0 | 19.4 | **-0.8%** |
| - | D. **Total Retail Sales $ Billions** [Conference Board of Canada][26] | $806.6 | $929.5 | **3.4%** |
| - | E. **Online Sales %** (Assume CBRE 2021 % today and 2026 % out to 2028)[27] | 20% | 27% | |
| DxE | F. **Online (E-Commerce) Sales $ Billions** | $161.3 | $251.0 | **11.0%** |
| D-F | G. **Bricks and Mortar Retail Sales $ Billions** | $645.3 | $678.5 | **1.2%** |
| F/A | H. **Bricks and Mortar Sales per sf** | $781.35 | $811.59 | **0.9%** |
| J/H | I. **GROC** (Assume 9.0% in 2028) | 8.9% | **9.0%** | |
| - | J. **Gross Rent per sf** [CBRE][28] | $69.26 | $73.04 | **1.3%** |

Figure 13 shows the Conference Board of Canada reported that today's retail sales were $806.6 billion, so by applying CBRE's 20% online sales ratio discerns that $161.3 billion was online sales and $645.3 billion was bricks and mortar.

Fast forward to 2028, the Conference Board forecasts $929.5 billion of total retail sales. Assuming CBRE's estimate of 27% carries into 2028, the numbers break down to $251.0 billion online versus $678.5 billion in bricks and mortar. Online should grow at a robust compounded annual growth rate ("CAGR") of 11.0% versus bricks and mortar's muted 1.2%.

If these forecasts come to pass, the conclusion is that online retail sales grow at a rate over 3x total retail sales and over 9x bricks and mortar sales – a very large bifurcation.

Furthermore, to translate this into rental growth, it is estimated that bricks and mortar sales per sf grow from $781.35 to $811.59 in 2028. Applying a stabilized GROC ratio of 9.0% in 2028 implies that gross rents grow from $69.26 now to $73.04 in 2028, or a CAGR of only 1.3%. This growth rate appears meager and when looking at Oxford Economics' forecast for Canada's inflation rate from 2024-2028 of 2.3% annualized,[29] it appears that the sector will offer investors rental growth that does not keep pace with inflation.

# The Verdict on Retail

The Canadian retail real estate sector has experienced significant changes due to the rise of e-commerce, which has led to a shift in investor focus from retail to industrial properties. Although industrial real estate has outperformed retail for many years, recent trends show a renewed interest in retail, particularly as it began to outpace industrial returns in Q2 2023. Despite this, Canada remains over-retailed and over-leveraged, with high consumer debt and potential mortgage rollover risks threatening future consumer spending. Even with strong immigration, the growth in wages and population is more likely to funnel into online sales rather than physical stores, particularly affecting discretionary bricks and mortar retail. In contrast, consumer staple retail (food and drug anchored centres), is less susceptible to these economic cycles and tends to benefit from steady population growth. This segment is also less likely to be fully digitized, ensuring its continued relevance in the retail space.

From a product/tenant quality perspective, luxury and discount retail segments have shown resilience, with luxury catering to experiential shopping and discount stores appealing to budget-conscious consumers. Middle-market retailers continue to be forgotten and digitized as more of these tenants face the prospects of bankruptcy or collapsing the scope of their businesses to preserve dwindling margins. Quite frankly, Amazon continues to eat their lunch.

Since 2018, retail valuations have rightfully adjusted to higher yields, as institutional investors began abandoning their allocations in the sector. The limited supply of new retail spaces, mostly delivered through mixed-use developments, and shrinking tenant footprints has allowed Canada to slightly grow into its retail, but its per capita figure remains relatively high compared to the developed world. Conducting the math on this, gross rents in this sector should grow at 1.3% annualized from now until 2028. This is underwhelming growth when viewed against Oxford Economics' 2.3% annualized inflation rate for Canada during that period and the impressive 11.0% growth rate that is expected for online/e-commerce sales.

Overall, the outlook for Canadian retail real estate is mixed, with online sales expected to grow significantly faster than bricks and mortar sales, leading to muted rental growth in the physical retail sector that will struggle to match inflation rates. The long-term value proposition for retail is one of providing steady and higher income yields with muted rental growth. Unlike the industrial and multi-residential sectors, retail will likely not benefit from significant structural tailwinds.

***To address the question, "Is it time to start allocating to retail?" it is important not to overreact to retail's recent outperformance. Unlike the strong "overweight" recommendations Fiera Real Estate has made for industrial and multi-residential sectors in previous reports, retail should be viewed as a "neutral" benchmark weight with thoughtful asset selection, to offer stability within a diversified Canadian real estate portfolio.***

## Contact Information

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